Report

of the

Examination of

Northeastern Mutual Insurance Company

Algoma, WI

As of December 31, 2001

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**State of Wisconsin** / OFFICE OF THE COMMISSIONER OF INSURANCE

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***Connie L. O'Connell,*** *Commissioner*

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June 14, 2002

Honorable Connie L. O'Connell
Commissioner of Insurance
State of Wisconsin
121 East Wilson Street
Madison, Wisconsin 53702

Commissioner:

In accordance with your instructions, an examination has been performed as of December 31, 2001, of the affairs and financial condition of

NORTHEASTERN MUTUAL INSURANCE COMPANY
Algoma, WI

and the following report thereon is respectfully submitted:

## I. INTRODUCTION

The last examination of this company was made in 1997 as of December 31, 1996. The current examination covered the intervening time period ending December 31, 2001, and included a review of such subsequent transactions deemed essential to complete this examination.

The Summary of Examination Results contains elaboration on all areas of the company's operations. Special attention was given to the action taken by the company to satisfy the recommendations and comments made in the previous examination report.

The company was originally organized as a town mutual insurance company on November 21, 1874, under the provisions of the then existing Wisconsin Statutes. The original name of the company was the German Mutual Farmers' Fire Insurance Company. Subsequent amendments to the company's articles and bylaws changed the company's name to that presently used.

During the period under examination, there were no amendments to the articles of incorporation or to the bylaws.

A review of the certificate of authority revealed that the company is currently licensed to write business in the following counties:

Brown, Door, Kewaunee, and Manitowoc

The company is currently licensed to write windstorm and hail, property, and nonproperty insurance.

A review was made of the policy and application forms currently used by the company. The company issues an approved policy with or without endorsements for terms of one or three years with premiums payable on the advance premium and installment bases. The company charges policyholders a service fee of $2/payment term, varying by the installment plan selected. In addition, the company collects policy fees to be paid to agents as noted below.

Business of the company is acquired through thirty agents, one of whom is a director of the company. Agents are presently compensated for their services as follows:

| Type of Policy | Compensation |
|---|---|
| Fire only | 10% |
| Fire and Extended Coverage, not commercial or public property (includes Homeowner's, Farmer's, Liability) | 15 |
| Fire and Extended Coverage, commercial or public property | 12 |

In addition, agents receive a policy fee of $4.00 per policy and $2.00 per addition to an existing policy.

Agents have authority to adjust losses up to $500. Losses in excess of this amount are adjusted by one of the four adjusters appointed by the company, as noted in the Committees of the Board section below. Adjusters receive $15.00 for each loss adjusted and an additional $10.00 per hour for each hour after the first, plus $0.30 per mile for travel allowance. The same compensation is paid to the secretary/treasurer when performing inspections. An outside inspector is compensated at $15.00 per hour.

Policyholders may participate in the management and control of the company by attending and voting at all annual or special meetings of the members. No member may vote by proxy. The annual meeting of the company for the election of directors and special meetings of the company are held in accordance with its articles of incorporation.

**Board of Directors**

The board of directors consists of seven members divided into three classes. One class is elected at each annual meeting for a term of three years. Vacancies on the board may be filled by the directors for the interim to the next annual meeting when a director shall be chosen for the unexpired term.

The current board of directors consists of the following policyholders of the company:

| Name | Principal Occupation | Residence | Expiry |
|---|---|---|---|
| Beverly Diefenbach | Company assistant Secretary/Treasurer | Algoma | 2004 |
| Kenneth Draves | Farmer | Algoma | 2003 |
| Dana Gruetzmacher | Farmer | Kewaunee | 2004 |
| Clayton Haen, Jr. | Plumbing & Heating | Sturgeon Bay | 2002 |
| Kenneth Karnitz* | Company Secretary/Treasurer; Insurance Agent | Algoma | 2002 |
| Milton Rodrian | Retired | Algoma | 2003 |
| Roger Schopf | Farmer | Sturgeon Bay | 2002 |

Directors who are also agents are identified with an asterisk.

Members of the board currently receive $50.00 for each half-day meeting attended and $100.00 for each full-day meeting attended and $0.30 per mile for travel expenses.

**Officers**

Officers are elected by the board of directors from among its members and hold office for one year or until their successors are duly elected and qualified.

Officers serving at the present time are as follows:

| Name | Office | Annual Salary |
|---|---|---|
| Kenneth Draves | President | $ 825 |
| Dana Gruetzmacher | Vice President | 0 |
| Kenneth Karnitz | Secretary/Treasurer | 13,027 |
| Beverly Diefenbach | Asst. Secretary/Treasurer | 20,136 |

**Committees of the Board**

The company's bylaws allow for the formation of certain committees by the board of directors. The committees at the time of the examination are listed below:

**Adjusting Committee**

Kenneth Karnitz, Chairman
Kenneth Draves
Dana Gruetzmacher
Clayton Haen

**Investment/Finance Committee**

Kenneth Karnitz, Chairman
Kenneth Draves
Milton Rodrian
Roger Schopf

**Growth of Company**

The growth of the company during the past five years as compiled from its filed annual statements was as follows:

| Year | Net Premiums Earned | Net Losses and LAE Incurred | Policies In Force | Net Income | Admitted Assets | Policyholders' Surplus |
|---|---|---|---|---|---|---|
| 1997 | $455,957 | $345,582 | 1,982 | $(40,959) | $1,973,839 | $1,362,534 |
| 1998 | 423,247 | 477,811 | 1,854 | (185,244) | 1,801,739 | 1,219,797 |
| 1999 | 439,031 | 311,712 | 1,683 | (28,628) | 1,632,833 | 1,166,697 |
| 2000 | 412,682 | 252,407 | 1,510 | 24,857 | 1,691,734 | 1,275,155 |
| 2001 | 398,209 | 166,533 | 1,448 | 84,502 | 1,749,344 | 1,342,877 |

The ratios of premiums written, gross and net, to surplus as regards policyholders during the past five years were as follows:

| Year | Gross Premiums Written | Net Premiums Written | Ending Surplus | Writings Ratios Gross | Writings Ratios Net |
|---|---|---|---|---|---|
| 1997 | $961,788 | $431,241 | $1,362,534 | 71% | 32% |
| 1998 | 973,261 | 436,507 | 1,219,797 | 80 | 36 |
| 1999 | 888,054 | 392,182 | 1,166,697 | 76 | 34 |
| 2000 | 799,600 | 380,528 | 1,275,155 | 63 | 30 |
| 2001 | 771,572 | 396,685 | 1,342,877 | 57 | 30 |

For the same period, the company's operating ratios were as follows:

| Year | Net Losses and LAE Incurred | Other Underwriting Expenses Incurred | Net Earned Premiums | Loss Ratio | Expense Ratio | Composite Ratio |
|---|---|---|---|---|---|---|
| 1997 | $345,582 | $192,630 | $455,957 | 76% | 45% | 120% |
| 1998 | 477,811 | 215,184 | 423,247 | 113 | 49 | 162 |
| 1999 | 311,712 | 193,402 | 439,031 | 71 | 49 | 120 |
| 2000 | 252,407 | 174,071 | 412,682 | 61 | 46 | 107 |
| 2001 | 166,533 | 171,616 | 398,209 | 42 | 43 | 85 |

Company policy count has decreased 27% over the period of examination from 1,982 in 1997 to 1,448 in 2001. The company contributes the decreasing policy count to the company's improved underwriting policy. Gross premiums written have decreased 24.7% from 1997 to 2001, which reflects the decrease in policy count. Total admitted assets have decreased from $1.97 million in 1997 to $1.75 million in 2001 or 11%. Total liabilities decreased from $611,305 in 1997 to $406,467 in 2001 or 33.5%. Surplus decreased 14% from 1997 to 1999 but has recovered most of the decrease from 1999 to 2001. Although the company has experienced decreased premium and assets, Northeastern has produced net income two of the last five years. The company's 2001 underwriting income of $60,060 is the first year the company reported underwriting income in the previous ten years.

## II. REINSURANCE

The examiners' review of the company's reinsurance portfolio revealed there is currently one ceding treaty. The treaty contained a proper insolvency clause and complied with s. Ins 13.09 (3), Wis. Adm. Code, concerning maximum wind loss. Company retention of risk complied with s. Ins 13.06, Wis. Adm. Code.

| | |
|---|---|
| Reinsurer: | Wisconsin Reinsurance Corporation |
| Effective date: | January 1, 2002 |
| Termination provisions: | May terminate by either party on any January 1, providing 90 days' advance notice in writing |

The coverages provided under this treaty are summarized as follows:

| | | |
|---|---|---|
| 1. | Type of contract: | Class A, Excess of Loss (Liability) |
| | Lines reinsured: | Nonproperty |
| | Company's retention: | $1,500 for each and every loss and an additional $1,000 for raw milk contamination losses |
| | Coverage: | 100% of each loss occurring on covered business subject to the following limits<br>a. $1,000,000 per occurrence, single limit, combined for bodily injury and property damage liability<br>b. $1,000,000 split limits, in any combination of bodily injury and property damage liability<br>c. $5,000 for medical payments, per person; $25,000 per accident |
| | Reinsurance premium: | 71.5% of premium written with respect to the business covered under this contract |
| 2. | Type of contract: | Class B, First Surplus |
| | Lines reinsured: | Property |
| | Company's retention: | If net retention is $200,000 or more on a risk, company may cede on a pro rata basis up to $800,000. If net retention is $200,000 or less, company may cede up to 50% on a pro rata basis |
| | Annual aggregate deductible: | The Company retains the first 10% of losses and loss adjusting expenses otherwise recoverable |
| | Coverage: | Up to $800,000 on a pro rata basis when the company's net retention is $200,000 or more in respect to a risk; when the net retention is less than $200,000, the company may cede on a pro rata basis up to 50% of such risk |
| | Reinsurance premium: | Pro rata portion of premium |
| | Ceding commission: | 15.0% sliding scale<br>Minimum = 15.0%<br>Maximum = 35.0% |
| 3. | Type of contract: | Class C-1, Excess of Loss |

| | | |
|---|---|---|
| | Lines reinsured: | Property |
| | Company's retention: | $35,000 in respect to each and every risk resulting from one loss occurrence |
| | Annual aggregate deductible: | First $30,000 of paid losses otherwise recoverable shall be retained by the company, subject to the class D/E stop loss reinsurance |
| | Coverage: | 100% of any loss, excluding LAE, in excess of $30,000 up to $65,000 |
| | Reinsurance premium: | For each annual period, calculated as the sum of the losses incurred by the reinsurer under this contract in the four years preceding the year just concluded, divided by the total net premiums written for the same period, multiplied by the factor 100/80ths. |

| | |
|---|---|
| Minimum rate: | 6.00% of net written premiums |
| Maximum rate: | 23.20% of net written premiums |
| Current rate: | 12.50% of net written premiums |
| Premium deposit: | $50,100 |

| | | |
|---|---|---|
| 4. | Type of contract: | Class C-2, Excess of Loss Second Layer |
| | Lines reinsured: | Property |
| | Company's retention: | $100,000 |
| | Coverage: | 100% of any loss, excluding LAE, in excess of retention up to $100,000 |
| | Reinsurance premium: | 1.6% of net premiums written, subject to an annual deposit premium of $7,200 |
| 5. | Type of contract: | Class D/E, Stop Loss |
| | Lines reinsured: | All business including nonproperty |
| | Company's retention: | 75% of net premium written |
| | Coverage: | Excess of 75% of net premium written, with minimum retention of $265,000. |
| | Reinsurance premium: | For each annual period, calculated as the sum of the losses incurred by the reinsurer under this contract in the eight years preceding the year just concluded, divided by the total net premiums written for the same period multiplied by the factor 100/80ths |

| | |
|---|---|
| Minimum rate: | 6.50% of net written premium |
| Maximum rate: | 25.00% of net written premium |
| Current rate: | 6.50% of net written premium |
| Annual deposit premium: | $28,500 |

## III. FINANCIAL DATA

The following financial statements were filed with the Commissioner of Insurance in the company's annual statement at December 31, 2001. Adjustments made as a result of the examination are noted at the end of this section in the area captioned "Reconciliation of Policyholders' Surplus."

**Northeastern Mutual Insurance Company**
**Statement of Assets and Liabilities**
**As of December 31, 2001**

| Assets | Ledger | Nonledger | Not Admitted | Net Admitted |
|---|---|---|---|---|
| Cash Deposited in Checking Account | $ 37,795 | | | $ 37,795 |
| Cash Deposited at Interest | 498,493 | | | 498,493 |
| Bonds (at Amortized Cost) | 134,640 | | | 134,640 |
| Stocks or Mutual Fund Investments (at Market) | 935,923 | | | 935,923 |
| Real Estate (Net of Accumulated Depreciation and Encumbrances) | 4,127 | | | 4,127 |
| Premiums and Agents' Balances In Course of Collection | 22,734 | | | 22,734 |
| Premiums, Agents' Balances, and Installments Booked but Deferred and Not Yet Due | 101,726 | | | 101,726 |
| Investment Income Due or Accrued | 5,140 | | | 5,140 |
| Reinsurance Recoverable on Paid Losses and LAE | 4,825 | | | 4,825 |
| Electronic Data Processing Equipment – Excluding Software (Cost Less Accumulated Depreciation) | 2,250 | | | 2,250 |
| Fire Dues Recoverable | 57 | | | 57 |
| Other Assets: | | | | |
| Federal Income Tax Refund Receivable | 1,651 | | | 1,651 |
| Other Assets | (17) | | | (17) |
| Furniture and Fixtures | 9,778 | | 9,778 | 0 |
| TOTALS | $1,759,122 | $ | $9,778 | $1,749,344 |

**Liabilities and Surplus**

| | |
|---|---|
| Net Unpaid Losses | $ 19,597 |
| Unpaid Loss Adjustment Expenses | 1,483 |
| Commissions Payable | 27,164 |
| Unearned Premiums | 320,223 |
| Reinsurance Payable | 28,029 |
| Amounts Withheld for the Account of Others | 1,343 |
| Payroll Taxes Payable | 315 |
| Other Liabilities: | |
| Expense Related | |
| Accounts Payable | 213 |
| Policy Fees Payable to Agents | 636 |
| Nonexpense Related | |
| Premium Received in Advance | 7,464 |
| TOTAL LIABILITIES | 406,467 |
| Policyholders' Surplus | 1,342,877 |
| TOTAL | $1,749,344 |

**Northeastern Mutual Insurance Company**
**Statement of Operations**
**For the Year 2001**

| | |
|---|---|
| Net Premiums and Assessments Earned | $398,209 |
| | |
| Deduct: | |
| Net Losses Incurred | 146,823 |
| Net Loss Adjustment Expenses Incurred | 19,710 |
| Other Underwriting Expenses Incurred | 171,616 |
| | |
| Total Losses and Expenses Incurred | 338,149 |
| | |
| Net Underwriting Gain (Loss) | 60,060 |
| | |
| Net Investment Income: | |
| Net Investment Income Earned | 29,970 |
| Net Realized Capital Gains | 1,135 |
| Total Investment Income | 31,105 |
| | |
| Other Income: | |
| Miscellaneous Income | (572) |
| | |
| Total Other Income | (572) |
| | |
| Net Income (Loss) Before Policyholder Dividends and Before Federal Income Taxes | 90,593 |
| | |
| Net Income (Loss) Before Federal Income Taxes | 90,593 |
| | |
| Federal Income Taxes Incurred | 6,091 |
| | |
| Net Income (Loss) | $ 84,502 |

**Northeastern Mutual Insurance Company**
**Reconciliation and Analysis of Surplus as Regards Policyholders**
**For the Five-Year Period Ending December 31, 2001**

The following schedule is a reconciliation of surplus as regards policyholders during the period under examination as reported by the company in its filed annual statements:

| | **1997** | **1998** | **1999** | **2000** | **2001** |
|---|---|---|---|---|---|
| Surplus, beginning of year | $1,355,637 | $1,362,534 | $1,219,797 | $1,166,697 | $1,275,155 |
| Net income | (40,959) | (185,244) | (28,628) | 24,857 | 84,502 |
| Net unrealized capital gains or (losses) | 47,711 | 43,351 | (24,733) | 83,377 | (16,465) |
| Change in non-admitted assets | 145 | (844) | 261 | 224 | (315) |
| Surplus, end of year | $1,362,534 | $1,219,797 | $1,166,697 | $1,275,155 | $1,342,877 |

## Reconciliation of Policyholders' Surplus

The examination resulted in no adjustments to policyholders' surplus. The amount reported by the company as of December 31, 2001 is accepted.

## IV. SUMMARY OF EXAMINATION RESULTS

**Compliance with Prior Examination Report Recommendations**

Comments and recommendations contained in the last examination report and the action taken on them by the company are as follows:

1. Committees of the Board—It is recommended that the finance committee meet regularly to review all investment transactions occurring in the preceding period.

   Action—Compliance.

2. Corporate Records—It is recommended that the company maintain complete board minutes and include therein copies of any relevant reports reviewed at board meetings; including, but not limited to, the treasurer's reports and loss summaries.

   Action—Compliance.

3. Conflict of Interest—It is recommended that the officers and directors who are agents for Northeastern or other insurance companies clearly report this on their annual conflict of interest statement.

   Action—Compliance.

4. Underwriting—To ensure that the company is not held liable for any loss payment over the intended percentage in a risk-sharing situation, it is recommended that the company policy files include documentation to verify that there is coverage provided by another insurer and that the same type of policy with the same conditions has been issued.

   Action—Compliance.

5. Underwriting—It is further recommended that the following issues be addressed:

   a) An originating insurer be identified pursuant to s. 612.31(5), Wis. Stat., in which the policyholder shall solely have voting rights;

   b) The policies that are written on a risk-sharing basis be amended so that each company is writing a policy with the same terms/conditions;

   c) The policies contain a notice of the shared coverage, identifying the companies involved.

   Action—Compliance.

6. Claims Adjusting—It is recommended that the adjusting committee meet regularly to review adjusting decisions, keep minutes of such meetings, and report regularly to the full board.

   Action—Compliance.

7. Claims Adjusting—Pursuant to s. Ins 13.05 (4) (e), Wis. Adm. Code, it is recommended that the company establish an amount above which claims shall be approved by more than one officer, director, or employee of the company.

   Action—Compliance.

8. Business Plan—It is recommended that the company prepare reports by agent, and by line of business if deemed appropriate, that track loss frequency and severity for the past four years or such length of time as reliable information is reasonably available.

   Action—Compliance.

9. Business Plan—It is further recommended that these loss analysis reports be regularly reviewed by the board of directors and utilized in prioritizing inspections and evaluating the adequacy of premium rates.

   Action—Compliance.

10. Business Plan—It is recommended that the company establish a formal inspection procedure for new and renewal business, whereby all new applications and all renewal business is inspected by committee members or employees independent of the risk under consideration. This plan should address the qualifications of an inspector, the anticipated time frame for inspecting all properties insured by the company, and records to be maintained of inspection results.

    Action—Compliance.

11. Business Plan—It is further recommended that the company submit its inspection plan to the Office of the Commissioner of Insurance for approval within 60 days of the adoption of this report.

    Action—Compliance.

12. Business Plan—It is recommended that the company develop a system of tracking statistics by agent or agency concerning new and renewal applications; including information on applications rejected, sent back for further information, or granted an exception to underwriting standards by company personnel.

    Action—Compliance.

13. Business Plan—In addition, it is recommended that the company establish specific agent performance standards.

    Action—Compliance.

14. Disaster Recovery Plan—It is recommended that the company develop a formal, written disaster recovery plan addressing these areas of concern.

    Action—Compliance.

15. Invested Assets—It is recommended that the company comply with the requirements of s. Ins 6.20 (6) (c), Wis. Adm. Code.

    Action—Compliance.

16. Cash and Invested Cash—It is recommended that deposits in one bank generally not exceed the $100,000 FDIC-insured limit.

    Action—Compliance.

17. Net Unpaid Losses—It is recommended that the company document dates of responses to claimants to track compliance with s. Ins 6.11 (3), Wis. Adm. Code.

    Action—Compliance.

## Current Examination Results

### Corporate Records

The minutes of the annual meetings of policyholders and meetings of the board of directors and any committees thereof, were reviewed for the period under examination and also for the subsequent current period.

Biographical data relating to company officers and directors have been reported in accordance with the provisions of s. Ins 6.52, Wis. Adm. Code.

The company has executed formal written agreements with its agents. The contracts include language indicating the agent will represent the company's interests "in good faith."

### Conflict of Interest

In accordance with a directive of the Commissioner of Insurance, each company is required to establish a procedure for the disclosure to its board of directors of any material interest or affiliation on the part of its officers, directors, or key employees which conflicts or is likely to conflict with the official duties of such person. A part of this procedure is the annual completion of a conflict of interest questionnaire by the appropriate persons. The company has adopted such a procedure for disclosing potential conflicts of interest. Conflict of interest questionnaires were reviewed for the period under examination with no apparent conflicts being noted.

### Fidelity Bond and Other Insurance

The company is afforded coverage under the terms of the following bonds or contracts and has complied with s. Ins 13.05 (6), Wis. Adm. Code, which sets forth the minimum requirements for fidelity bond coverage:

| Type of Coverage | Coverage Limits |
|---|---|
| Fidelity Bond Coverage | |
| Crime General and Employee Dishonesty—Secretary-Treasurer [covers Asst. Secretary-Treasurer in absence of Secretary-Treasurer] | $110,000 |
| Home Office Coverage | |
| Building Coverage | 90,000 |
| Business Personal Property | 20,000 |
| Professional Liability | 1,000,000 |
| Worker Compensation | |
| Bodily Injury by Accident—each accident | 100,000 |
| Bodily Injury by Disease—policy limit | 500,000 |
| Bodily Injury by Disease—each employee | 100,000 |
| Business Owners | |
| Commercial Liability—per occurrence | 1,000,000 |

| | |
|---|---|
| Completed Work General | 2,000,000 |
| Products/Completed Work | 1,000,000 |
| Medical payments—per person | 5,000 |
| Non-Owned Auto Liability—per occurrence | 1,000,000 |
| Hired Auto Liability—per occurrence | 1,000,000 |
| Fire Legal Liability—per occurrence | 50,000 |

**Underwriting**

The company has a written underwriting guide. The guide covers all the lines of business that the company is presently writing.

The company has a formal inspection procedure for both new and renewal business. A sampling of new applications and of renewal business is inspected by committee members independent of the risk under consideration and review.

**Claims Adjusting**

The company has an adjusting committee consisting of four directors as required by s. 612.13 (4), Wis. Stat. The function of this committee is to adjust or supervise the adjustment of losses. Examiners discussed with the company its procedure for adjusting claims and concludes that it is appropriate for timely assessment and payment of claims. Upon request, the company was unable to provide a written policy for adjusting claims. Although no inadequacies were noted concerning the company's procedure for adjusting claims, it is suggested that the company create a written policy to facilitate the adjusting procedure.

**Accounts and Records**

The examiners' review of the company's records indicated that the company is in compliance with s. Ins 13.05, Wis. Adm. Code, which sets forth the minimum standards for the handling of cash and recording of cash transactions by town mutual insurance companies. The examiners noted the following:

1. A proper policy register is maintained
2. A proper cash receipts journal is maintained
3. A proper cash disbursements' journal is maintained
4. A proper general journal is maintained
5. A proper general ledger is maintained

An extensive review was made of income and disbursement items. Cash receipts were traced from source records and the proper recording and eventual deposit thereof ascertained. Negotiated checks issued during the period under examination were reviewed, test checked for proper endorsement, and traced to cash records. The verification of assets and determination of liabilities were made as of December 31, 2001.

The company is audited annually by an outside public accounting firm.

**EDP Environment**

Company personnel were interviewed with respect to the company's Electronic Data Processing environment. Access to the computer is limited to people authorized to use the computers. Company personnel back up the computers daily and the backed-up data is kept off-site.

A manual which describes how to use the company's software and outlines the steps to complete specific tasks assists in the continuity of operations for seldom-used applications, training, or when staff turnover occurs. The company has manuals documenting the use of its software.

**Disaster Recovery Plan**

A disaster recovery plan identifies steps to be performed in case the company loses a key employee, is not able to access its computer, information on its computer was lost, or the office building was destroyed, to name a few contingencies. The company has developed a disaster recovery plan. The company's disaster recovery plan was reviewed and appears to be adequate.

**Premiums In Force**

Examination of premium in-force noted that the company's annual statement reports gross premium and total premium in-force to be $771,572. The company's computer system reports total premium in-force to be $781,439. The difference is primarily due to the three-year term policies that should be included in premium in-force. Examiner concludes that total premium in-force reported on the company's computer system is the correct amount. It is recommended that the company use reports generated from their computer system to calculate the correct amount of total premium in-force, which will be reported on the annual statement.

**Invested Assets**

Section 610.23, Wis. Stat., requires insurers to hold all investments and deposits of its funds in its own name except that:

(1) Securities kept under a custodial agreement or trust arrangement with a bank or banking and trust company may be issued in the name of a nominee of the bank or banking and trust company; and

(2) Any insurer may acquire and hold securities in bearer form.

For securities not held under a custodial agreement or trust arrangement with a bank or banking and trust company, s. Ins 13.05 (4), Wis. Adm. Code, requires that:

> Non-negotiable evidences of company investments such as registered bonds, certificates of deposits, notes, etc., shall be maintained in a safe or vault with adequate safety controls or in a safety deposit box in a bank. Negotiable

> evidences of company investments shall be maintained in a safety deposit box in a bank. Access to a company safety deposit box containing negotiable securities shall require the presence and signature of at least 2 officers, directors or employees of the company.

The company is not in compliance with these requirements. During the course of examination, an examiner went with Assistant Treasurer/Secretary to view certificates of deposit. The bank required only one signature to access the safe deposit box. It is recommended that the company have access to the safe deposit box only with signatures of two directors, officers, or employees pursuant to s. Ins 13.05(4), Wis. Adm. Code. During examination, it was noted that the company in violation of s. 610.23 Wis. Stat. allowed its broker to hold the company bonds. It is recommended that the company hold its securities under a custodial or trust arrangement with a bank or banking and trust company or otherwise comply with s. 610.23 Wis. Stat.

**Investment Rule Compliance**

The investment rule for town mutuals allows a company to invest in common stocks, common stock mutual funds, and other higher risk investments (referred to as “Type 2”) provided that the town mutual has a sufficient amount of lower risk investments (referred to as “Type 1”). A town mutual may invest in Type 2 securities only if it already has sufficient Type 1 investments. Type 1 investments must equal or exceed the greater of items 1, 2, or 3.

| | | |
|---|---|---|
| 1. | Liabilities plus $300,000 | $706,467 |
| 2. | Liabilities plus 33% of gross premiums written | 661,086 |
| 3. | Liabilities plus 50% of net premiums written | 604,810 |
| 4. | Amount required (greater of 1, 2, or 3) | 706,467 |
| 5. | Amount of Type 1 investments as of 12/31/2001 | 737,022 |
| 6. | Excess or (deficiency) | $ 30,555 |

The company has sufficient Type 1 investments.

## ASSETS

**Cash and Invested Cash** **$536,288**

The above asset is comprised of the following types of cash items:

| | |
|---|---|
| Cash deposited in banks-checking accounts | $ 37,795 |
| Cash deposited in banks at interest | 498,493 |
| Total | $536,288 |

Cash deposited in banks subject to the company's check and withdrawal consists of one account maintained in a local bank. Verification of checking account balance was made by obtaining confirmation directly from the depository and reconciling the amount shown thereon to company records.

Cash deposited in banks represents the aggregate of five deposits in five depositories. Deposits were verified by direct correspondence with the respective depositories and by an actual count and inspection of certificates and/or passbooks. Interest received during the year 2001 totaled $10,200 and was verified to company cash records. Rates of interest earned on cash deposits ranged from 1.49% to 4.89%. Accrued interest on cash deposits totaled $4,076 at year-end.

**Book Value of Bonds** **$134,640**

The above asset consists of the aggregate book value of bonds held by the company as of December 31, 2001. Bonds owned by the company are located with the broker. See recommendation under the caption, “Invested Assets.” Bond purchases and sales for the period under examination were checked to brokers' invoices and advices. The company's investment in bonds was in conformance with Wisconsin Statutes and the rules of the Commissioner of Insurance as regards investments made by town mutual insurers.

Interest received during 2001 on bonds amounted to $9,781 and was traced to cash receipts records. Accrued interest of $1,194 at December 31, 2001, was checked and allowed as a nonledger asset.

**Stocks and Mutual Fund Investments** **$935,923**

The above asset consists of the aggregate market value of stocks and mutual funds held by the company as of December 31, 2001. Stocks owned by the company are located in a safe deposit box.

Stock certificates were physically examined by the examiners. Stock and mutual fund purchases and sales for the period under examination were checked to brokers' invoices and advices. The company's investment in stocks and mutual funds was in conformance with Wisconsin Statutes and the rules of the Commissioner of Insurance as regards investments made by town mutual insurers.

Dividends received during 2001 on stocks and mutual funds amounted to $18,787 and were traced to cash receipts records.

**Book Value of Real Estate** **$4,127**

The above amount represents the company's investment in real estate as of December 31, 2001. The company's real estate holdings consisted of land and building with book values of $1,341 and $2,786, respectively.

The required documents supporting the validity of this investment were reviewed and were in order. Adequate hazard insurance was carried on the real estate and contents as noted under the caption, "Fidelity Bond and Other Insurance." The company's investment in real estate and related items was in conformance with the Wisconsin Statutes and the rules of the Commissioner of Insurance as regards investments made by town mutual insurers. Real estate depreciation is calculated using the straight-line method.

**Premiums and Agents' Balances in Course of Collection** **$22,734**

The above ledger asset represents the amounts due from agents or policyholders which are not in excess of 90 days past due at year-end. A review of individual agent's accounts verified the accuracy of this asset.

**Premium, Agents' Balances, and Installments Booked But Deferred and Not Yet Due** **$101,726**

The above ledger asset represents the amounts due from policyholders which are not in excess of 90 days past due at year-end. A review of individual accounts verified the accuracy of this asset.

**Investment Income Due and Accrued** **$5,140**

Interest due and accrued on the various assets of the company at December 31, 2001, consists of the following:

| | |
|---|---|
| Interest accrued on cash deposits | $4,076 |
| Interest accrued on bonds | 1,064 |
| Total | $5,140 |

**Reinsurance Recoverable on Paid Losses** **$4,825**

The above asset represents recoveries due to the company from reinsurance on losses which were paid on or prior to December 31, 2001. A review of year-end accountings with the reinsurer and review of subsequent collection verified the above asset.

**EDP Equipment** **$2,250**

This asset consists of computer equipment. The amount reported is net of accumulated depreciation and excludes software. The examiners verified this asset amount by physical inspection and by viewing the invoice and cancelled checks.

**Fire Department Dues Recoverable** **$57**

This asset represents the fire department dues recoverable at December 31, 2001. The examiners reviewed the company's fire department dues calculation and found this asset to be correctly calculated.

**Federal Income Taxes Receivable** **$1,651**

This asset represents the balance receivable at year-end for federal income taxes incurred prior to December 31, 2001. The examiners verified the asset amount by reviewing the CPA's tax calculation.

**Other Assets** **$(17)**

This asset represents policy fees billed. Examiners verified the amount by reviewing a report of paid and billed policy fees.

**Equipment, Furniture, and Supplies** **$0**

This asset consists of $9,778 of furniture and equipment owned by the company and fully depreciated at December 31, 2001. In accordance with annual statement requirements, this amount has been deducted as an asset not admitted.

## LIABILITIES AND SURPLUS

**Net Unpaid Losses** **$19,597**

This liability represents losses incurred on or prior to December 31, 2001, and remaining unpaid as of that date. The examiners' development of unpaid losses is compared with the amount estimated by the company in the following schedule. Differences are reflected in the section of this report captioned "Reconciliation of Policyholders' Surplus."

| | Company Estimate | Examiners' Development | Difference |
|---|---|---|---|
| Incurred But Unpaid Losses | $29,666 | $36,319 | $(6,653) |
| Less: | | | |
| Reinsurance Recoverable on Unpaid Losses | 10,069 | 13,982 | (3,913) |
| Net Unpaid Losses | $19,597 | $22,337 | $(2,740) |

The examiners developed this liability by totaling actual loss payments made through the development period on those losses incurred on or prior to December 31, 2001. To the actual paid loss figures was added an estimated amount for those 2001 and prior losses remaining unpaid at the examination date. The above difference of $(2,740) was not considered material for purposes of this examination.

The examiners' review of claim files included open claims, paid claims, claims closed without payment, and all claims which were denied during the examination period. The review indicated that claims are investigated and evaluated properly and that payments are made promptly and in accordance with policy provisions upon the submission of a proper proof of loss. In addition, the review of claims handling procedures and files revealed the following:

1. A proper loss register is maintained.
2. Claim files contained sufficient investigatory data and documentation to verify settlement payments or reserve estimates.
3. Proofs of loss were properly signed.

**Unpaid Loss Adjustment Expenses** **$1,483**

This liability represents the company's estimate of amounts necessary to settle losses which were incurred prior to December 31, 2001, but which remained unpaid as of year-end. The methodology used by the company in establishing this liability is an estimate by the CPA using a percentage of gross unpaid losses based on historical data.

The examiners' analysis of expenses incurred in the current year related to the settlement of prior year losses, as well as estimates of amounts necessary to settle any prior losses remaining unpaid at the examination date, determined this liability to be adequately stated.

**Commissions Payable** **$27,164**

This liability represents commissions payable to agents as of December 31, 2001. The balance was verified by tracing agent balances in the commission register to subsequent payments in the check register.

**Unearned Premiums** **$320,223**

This liability represents the reserve established for unearned premiums in compliance with s. Ins 13.08 (3), Wis. Adm. Code. This reserve was established using a daily pro rata methodology.

**Reinsurance Payable** **$28,029**

This liability consists of amounts due to the company's reinsurer at December 31, 2001, relating to transactions which occurred on or prior to that date.

| | |
|---|---|
| Class A Liability Premium | $ (971) |
| Class C-1 Premium | 2,200 |
| Class C-2 Premium | 300 |
| Class D/E Premium | 2,000 |
| Deferred Premium | 24,500 |
| Total | $28,029 |

Subsequent cash disbursements and reinsurance accountings verified the amount of this liability.

**Amounts Withheld for the Account of Others** **$1,343**

This liability represents employee payroll deductions in the possession of the company at December 31, 2001. Employer’s federal tax return was reviewed to verify the amount.

**Payroll Taxes Payable** **$315**

This liability represents the company's portion of payroll taxes incurred prior to December 31, 2001, which had not yet been paid. The examiners analytically reviewed the general ledger and December 31, 2001 trial balance for reasonableness.

**Accounts Payable** **$213**

This liability represents bills that were payable at December 31, 2001. Supporting documents verified this amount.

**Policy Fees payable** **$636**

This liability represents the policy fees due to agents on premiums received during December 2001. Supporting records and subsequent cash disbursements verified this balance.

**Premiums Paid in Advance** **$7,464**

This liability represents premiums paid by policyholders in advance of the due date. During review of supporting documentation, examiners noted that all but one policy was within its policy term. One policy's anniversary date was 1/1/02 and premium for that policy was received in December; therefore, only one policy should be in advanced. Data that was provided from the company and analyzed using ACL also indicated that only one policy should be in advanced. Therefore, examiners are satisfied that advance premium should be $468. The difference between the annual statement amount and the examination amount is below tolerable error and no adjustment will be made. However, it is recommended that the company calculate advance premium correctly.

## V. CONCLUSION

Northeastern Mutual Insurance Company is a town mutual insurer authorized in four counties that writes windstorm and hail, property, and nonproperty insurance. The decrease in policy count over the examination period has decreased gross premium written but appears to have had a positive impact on losses and net income. Northeastern reported net income the last two of the five years under examination and underwriting income the first time in ten years. The examination of Northeastern Mutual Insurance Company resulted in four recommendations, a suggestion and no adjustment to surplus. The suggestion and recommendations are listed on the subsequent page.

## VI. SUMMARY OF COMMENTS AND RECOMMENDATIONS

1. Page 17 - Claims Adjusting—It is suggested that the company create a written policy to facilitate the adjusting procedure.

2. Page 18 - Premiums In Force—It is recommended that the company use reports generated from their computer system to calculate the correct amount of total premium in-force, which will be reported on the annual statement.

3. Page 19 - Investments—It is recommended that the company have access to safe deposit box only with two signatures of two directors, officers, or employee's pursuant to s. Ins 13.05(4), Wis. Adm. Code.

4. Page 19 - Investments—It is recommended that the company hold its securities under a custodial or trust arrangement with a bank or banking and trust company or otherwise comply with s. 610.23 Wis. Stat.

5. Page 25 - Premiums Paid In Advance—It is recommended that the company calculate advance premium correctly.

## VII. ACKNOWLEDGMENT

The courteous cooperation extended to the examiners by the company's personnel is hereby acknowledged.

In addition to the undersigned, Dave Grinnell of the Office of the Commissioner of Insurance, State of Wisconsin, participated in the examination:

Respectfully submitted,

Ryan J. Hanson
Examiner-in-Charge